Title: Insight – Conversations with CalPERS Leaders

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Rob Feckner:

And now we have a special treat for you. Last year we developed a new on-line video program called the Insight: Conversations with CalPERS Leaders. Today we're bringing Insight to this stage live with two of our CalPERS leaders Joe Dear, our Chief Investment Officer, and Alan Milligan, our Chief Actuary; they're here to discuss the important issues related to investments and employer pension liabilities. Now please join me in welcoming Joe and Alan along with our Insight host, Bob Burton. (Applause)

Bob Burton:

Good morning and welcome. I want to thank each and every one of you for choosing to be with us this morning. Estimating CalPERS assumed rate of return and the resulting impact on employer contributions is, of course, a hot button issue. These two gentlemen are important players in the process. Joe Dear, as you heard introduced earlier, joined us from the Washington State fund back in March 2009. And during his time with CalPERS, along with a little help from recovery, his leadership has put $60 billion back in the fund.

Alan Milligan, well I won't begin to list all the credentials you've heard earlier. He has more letters following his name than I have in my entire name. Alan became our Chief Actuary earlier this year and is obviously well equipped to deal with his responsibilities. Perhaps the most important, certainly one of the most important factors in the process that's of concern to everyone is market recovery. And I turn to you now to try and find out what you think about when you assess market recovery? Joe?

Joe Dear:

The returns we expect essentially relate to how the economy is going to perform over the longer term. When I think about long term, you watch CNBC; long term is the next 60 seconds. We have a different perspective in the investment office. We try look at over 5 to 10 years looking at our asset allocations, so you ask me what's a long term timeframe is for an investment program like ours, I would say around 10 years.

Bob Burton:
10 years. Alan?

Alan Milligan:
When we look at, in the actuarial office, when we look in the long term, we have to project out benefit payment streams that go out for 30, 40, 50, even out to 75 or more years. For me, long term is more like 75 years instead of 10 years. So that's a little bit of a different perspective.

Bob Burton:
We have a bit of a gap as you can see.

Joe Dear:
You can see what the staff meetings are like. I am worried about the long term. That's the short term. We'll recover.

Bob Burton:
Well, different view from different angles. When you assess long term, what factors do you weigh in?

Joe Dear:
Well when you're building an investment portfolio you're looking at what's the investable universe and how you can put it together, the returns you can expect and how much risk are you willing to take to do that. So when we estimate capital market returns, which are one of the fundamental steps to the strategic asset allocation process, Anne mentioned, Anne Stausboll mentioned in her talk, we're looking at well, what do we expect from equities and stocks. What do we expect from fixed income investments, government securities, bonds, mortgages? What do we expect from real estate, private

equity and inflation linked assets? How do we expect the prices of those assets to move into relation to each other? What can diversification do for us, what will doing well when something is doing poorly? And then how much risk is there in that portfolio, how much volatility, one of the main ways we think about risk, how much variation, year to year can we expect? And then we can put together various portfolios and show how they will perform in different economic environments over 5, 10 or longer time periods.

Bob Burton:
Alan, what factors do you figure in?

Alan Milligan:
Well, one of the most important factors that I need to consider is just what Joe is going to provide us with. Because the funding of the pension plan really comes down to what contributions are coming in from employers, what contributions are coming in from members and what investment income is going to provide. And the more that Joe can provide in the way of investment income, the less that we have to have in the way of employer contributions. So absolutely critical in that process in the funding process is to make an estimate of what investment returns we will achieve long term. And I am sorry Joe, it is not just the first ten years, it's long term. So that's really what we tend to focus on and then we do try to make sure that employer contributions have a certain amount of stability. We're in an environment right now where we did have the market losses in 2008-2009 and at the current time employer contribution rates are not really sufficient to make up for the short fall. This does not mean that we are counting on a recovery in the markets. What it means is we are gradually phasing in the increases so you haven't seen them yet, but they're scheduled to come. And you'll see that in your annual actuarial evaluation reports will give you an indication of where the contribution rates are going. But I can tell you right now that where they're going at the moment is up.

Bob Burton:
Joe some thought is being given to a possible adjustment in the 7.75% assumed rate of return. What's going to factor in on a change if it comes?

Joe Dear:

We're doing a huge amount of work on asset liability management. We've spent almost the entire year in a number of different education sessions with the board, bringing in experts and bringing in different points of view, doing it all in open public meetings. November 8th and 9th we'll do a day and a half workshop where we try to bring all these different view points together and help the board towards a set of choices which ultimately will culminate a portfolio that expresses our expected return and the risk appetite we have for the total fund. Risk being expressed along the lines that Alan mentioned. What would happen to contribution rates to various portfolios and what would happen to the funded status of the plan? As Bob said, we currently assume a return of 7.75%. After the crisis we have reduced our expectations for what we likely would receive over the next ten or so years. In equity markets downward and we've also adjusted the expected return for fixed income investments, again mortgages, bonds, government securities, corporate bonds, and so forth, downward because of the low interest rate environment. So even if we maintain the current level of risk we have in the portfolio, we would expect the return to come down from slightly over 8%, which is what we think the portfolio would produce, which in your term it has, down to about 7.4%. Now that's not a decision, that's just where the current risk level would leave us. That choice is for the board to make, advised by staff with various options. But in view of what's happened in the market and likely risk tolerances, it's probable that the rate of return that we expect will be reduced somewhat.

Bob Burton:

Alan, the rate these people pay, these employers out here pay is key to that assumed rate of return. What do you believe the impact of an adjustment in the return would be?

Alan Milligan:

Well, I think first we need to step back a little bit. The expected rate of return that Joe is talking about is the expected return over the next ten years. And that will change potentially depending upon the board's action in November and December. In February, we will be coming back to the board with a recommendation as to what to do with the return that we assume in the actuarial valuation, what I call the discount rate. The first step in coming up with that is to marry the expectation over the next ten years with an expectation for 10-75 years. And so that's going to change the expected return somewhat. The first ten years are very important. Because they affect all benefit payments. The returns on years 10-75 only affect the return on the benefit payments in those years. And the first 10 years aren't affected by them. But we also need to ask ourselves do we want to have any sort of element of conservatism. Even if we expect to get 7.5% long term, do we want to use 7.5% or do we want to use something slightly less. Just as a bit of history, last time we really went through this full process was in February 2008, almost three years ago and at that time, what we were expecting a return of just over 8.04% net of administrative expenses. And we elected, the board elected to go with a discount rate of 7.75%. So, that's a question, how much conservatism, that's also a question for the board and so we'll have that discussion at the benefits and program administration committee meeting in February.

Bob Burton:
Let's shift our attention now to asset review. Joe, the process of asset review and what you can expect in performance from those assets.

Joe Dear:
Well, the asset liability management study that we're currently conducting asks fundamental questions going back to what assumptions do we make about returns, the relationships of returns to each other and the risk levels of the return. Importantly we're trying to add lessons from the financial crisis to how we view risk. I mention risk as primarily a volatility and that's what conventional asset liability models would have us do. Well, we know there are risks to exposure of economic growth that cut across asset types and we know that there's risk of liquidity that is having cash on hand to meet benefit payments or calls for investment capital. So we have tried to find new ways to incorporate that. Plus we know that the economy shifts around, it's the capitalist economic system, there are cycles things go up and things go down. How do you invest

with some recognition that the cycles are possible? So we're adding new modeling tools to this asset liability. But scrape it all away and you come down to some fundamental judgments. They involve a set of difficult trade offs. If you want lower contribution rates, then you have to go for higher investment return. If you want higher investment return you're going to take more risk. Well what does more risk look like, well it's the chance that the portfolio can gain a lot; it's also the chance the portfolio could lose a lot. Portfolio loses a lot; contribution rates have to go up higher. So the trade off for higher returns is more volatility of contribution rates. You want to protect yourself from downside. We want to not have a loss like we experienced in fiscal 2009. Put some more downside protection, well we know that there are tools available that would do that, but if you want to protect yourself on the downside, you have to give up a return on the upside. How much of the trade off do you want to make, because that will feed back on the contribution plate. What is the risk tolerance in a fund which is at the funding level we currently have about 60%. Does it go up because we want to earn our way back to 100% and try to keep contribution rates as low as they could possibly be, or does it go down because we don't want to face what will happen if we have another crisis in the financial system and a decline of the contribution rate further below. So what we are trying to do, Bob, is do heavy duty quantitative modeling, apply a lot of theory and then on top of that importantly, add judgment. And it's really the judgment informed by the professional staff, the folks I work with and then the judgment of our board as they think about how the system needs to perform over the long term.

Bob Burton:
Alan, from an actuarial perspective, what do you consider when it comes to shaping a recommendation for a change in the rate.

Alan Milligan:
Really the critical things that I take into account are in fact, the expected return, both short term and longer term and what level of conservatism to include. It occurs to me that I failed to answer your last question Bob which is what do I expect the impact of a discount rate change to be on employers. A 0.25% reduction in the discount rate if the

board were to elect to change the discount rate from the current 7.75 to 7.5 that would probably increase contributions for miscellaneous plans about 2%, to a bit more than 2%, maybe as high as 3% for some of the most generous plans. The impact on a safety plan would be about double that. And if the board were to elect to reduce the discount rate by a half percent, the impact would be kind of double what I said, so you're looking at probably about a 4% increase for the miscellaneous plan. So this is something that is very serious, something we put a lot of thought into before we make a change. We don't just simply say oh look, people are criticizing us for what we are doing, let's make a change. No, this is something we have to think of very carefully before we do it because there are real consequences to our employers and we want to make sure we take everything into account before we make such a change.

Bob Burton:
Joe, you've said that when it comes to considering change, you'd to make it an open process, all voices at the table. Could you expand on that a bit?

Joe Dear:
Well, basically we're doing all the critical meetings in public. So anybody can show up and participate, since we're CalPERS we get a lot of attention naturally from the financial press and others, and we're trying to listen to the voices that have criticized how we've approached things. Some think the discount rate is too aggressive, some think the investment program has too much risk to incorporate that, to think about that and then to carefully consider these and come back. And again all of the decisions, the workshop in Sacramento on the 8th and 9th, anybody can show up and listen in. It's likely that the final decision on the portfolio will be made at the board's December meeting, but it doesn't end there. This is a continuous process. Another one of the changes that has happened recently is we're bringing in more experts into the education sessions as part of the regular board meetings. One of the neat things about being at CalPERS, you can call up any financial expert anywhere in the world and ask them if they would like to come and talk to the CalPERS board, and it's like what time do I need to be there. So we have had some fascinating; some really interesting folks come in and talk about it. So that's to

inform a very rich discussion about what's the best type of portfolio to have in this kind of investment environment.

Bob Burton:
Alan, what has CalPERS done to mitigate the affects of the recession on employers?

Alan Milligan:
Well probably the most significant thing that we've done was to phase in the impact of the investment loss in 2008-2009. We can't through actuarial magic make up for losses in the markets. We can smooth the loses, but smoothing is just smoothing, it doesn't create something from nothing and so we have phased in the impact of the investment losses over a three year period. And I guess the way I like to describe it, it's the difference between climbing a steep hill and climbing a cliff. You may have to climb the same distance, but it's a lot easier if it's a steep hill, than if it's a cliff and that's I think what employers are faced with. But we do hope that by doing this phase in we will have given you enough time to react and we've tried to really be open with you about what's coming. To make sure that you are aware of it and are planning for it to the best of your ability. I understand that may be somewhat constrained at the present time. But that is what we can do. Fundamentally though all of the actuarial work we can do is to smooth things out maybe give you a little bit of a chance, some time, some breathing room, we can't stop the increases. Joe might be able to, but we can't. (Laughter) this is a very important guy here. We really need him, really need him to do well. That's about it.

Bob Burton:
Joe, CalPERS, the fund has earned almost 8% since clear back to 1988. Given a little recovery, is the environment going to be much different in the future?

Joe Dear:
You know the four most dangerous words in investment is "it's different this time." There are some changes, but the fundamental forces which shape the economy, which guide investment don't really change. Alan is putting a little pressure on me over here.

But I think it's really important to try to step back and maintain some perspective, whether your long term is ten years or 75 years. It's no surprise following the crash, the financial crisis of 2007-2008; the more pessimistic voices are voiced more loudly and heard more often than voices of optimism. It's really the opposite of what we had 2005, 2006, and 2007, when it looked like trees grew to the sky and everything was great and no matter what you invested in you were going to make money with it. I think it's really important both for institutions like CalPERS, but also in our individual roles not to get swept away by too much optimism or too much pessimism, but try to maintain a grounded sort of realism. What would that tell us? Well, we know the capitalism system has its ups and downs, has its cycles, for a while we got lulled into thinking that maybe we had moderated some of the bigger swings that the problems of the past weren't going to come back, but we've been disabused to that notion. But those cycles are there. We're at a bottom cycle now, we're probably coming up, but it's easy to again, to think about what could go wrong and the pessimism and the fragility, the psychology of markets. But if you think about California, you think about the United States, you think about the developed world and you think about the emerging markets with an enormous number of people that are moving out of poverty into middle class. And you think, long term the investment opportunities are going to be there. I am really, quite confident of our ability to achieve a reasonable return in the 7 to 8% range over the long term. This requires skill; some criticize us for assuming that skill in our investment returns. I make no apology for that. I think you should expect, and we expect of ourselves, that we'll do a really good job. And we shouldn't assume mediocrity in what we do; we should have some confidence and some grounded realism about what's achievable. And over the long term it's achievable to earn our way to be able to fund a decent pension system for our colleagues and the people we work with. I really believe that.

Bob Burton:

Alan, we hear almost daily about local governments ratcheting back benefits in order to try to control costs. Is there anything that CalPERS can do to help them address that situation?

Alan Milligan:

Well, I think for the local public agencies, it's important to remember that there is a menu of benefits. But the actual benefits themselves that are promised by the local agencies are under the local agencies control. I am sure everybody in the room understands that. I'm not sure that the media always understands that. So the tools necessary to have an appropriate benefit level are available to local agencies. There's also a certain amount of flexibility in contribution rates that I know many public agencies, not all by any means, but many public agencies have picked up a portion of the employee contribution. That is also under their control. So most of this is really under the control of the local public agencies. It may be that there should be more options on the menu. And if that's the case, I would encourage all of you out there to talk to any of the CalPERS executives, to myself or Lori McGartland, about what you need. This is a great time to do that. We're really taking a hard look at this sort of thing. There's a session, I know Lori is going to be presenting at, tomorrow I think it is, I'm getting a nod, about this very topic and that would be a great place for you to communicate your thoughts back to us. I also have a session this afternoon, dialogue with a chief actuary, and I would be happy to hear your thoughts about what do you need is there an additional tool, is there something about the current menu of benefits that is a problem for you that we can address. So we'd really love to get your feedback.

Bob Burton:

Gentlemen, that brings us to time. Thank you for your insight. (Applause)